ABR Dynamic Funds' Portfolio Construction Series: Part 9

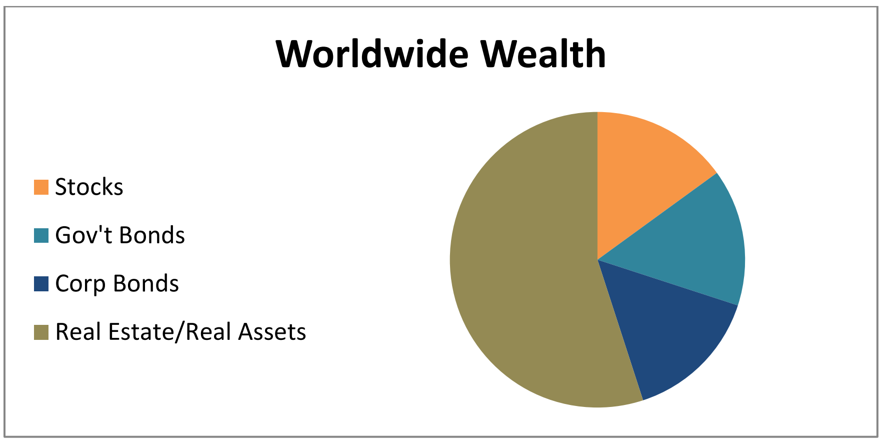
The Active vs. Passive debate is a red herring

Despite the endless TV time and column inches devoted to this lively debate, it is at best a waste of time. Everyone is active. It's a question of how much, not if.

Every portfolio has been actively managed. Furthermore, the frameworks and benchmarks of portfolios are often actively managed. Finally, the components of portfolios are actively managed.

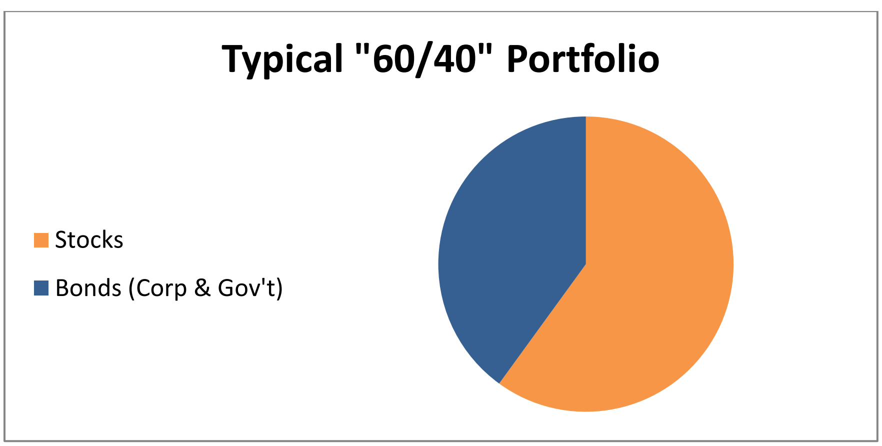
1. **Every portfolio has been actively managed.**

Don't believe us? The breakdown of worldwide wealth is roughly:



Source: BIS Savills

Most readers will not recognize the above portfolio as anything like their own portfolios, which have been actively managed to look more like some variant of:



2. **The indices that form the frameworks and benchmarks of those portfolios are often actively managed.**

For example, the S&P 500 has criteria, as well as a committee, which determine the stocks to include in it each quarter. That sounds an awful lot like the pitch from most active or hybrid managers.

3. **The equity and debt of companies that serve as the main components of portfolios are actively managed.**

Companies themselves adapt their businesses to changing conditions. When was the last time someone landed a top-dollar CEO position and said, "I do not intend to implement any ideas; we're going to continue just as though my office were vacant"?

It's a laughable pitch for CEOs. Why would it be a great idea for investors?

"Maybe it's a great idea for investors because studies show that people are bad at timing. After all, a typical investMENT has a higher return than its typical investOR."

We know that this rebuttal is on the tip of many tongues. And it is indeed true that there are studies which indicate people are generally lousy at timing. However, those studies don't lead to the conclusion that "passive" management is superior. In many cases, those studies simply indicate that when humans allow emotions and biases to affect decisions, those decisions can be detrimental. In other words, *the active vs. passive debate should not be confused with the systematic vs. discretionary debate*, which is not the subject of this installment.

60/40, or some other static allocation to stocks and bonds, is not passive management. It is an arbitrary stopping point for just one of the facets of the active management in all portfolios.

The three points above indicate that it is not a stretch to say all portfolios employ active management, sometimes for good reasons, such as risk and return, diversification, and liquidity.

But why settle on 60/40, or some variant of it, and then insist on being "passive" from there? There are better ways to invest, both over the long-term and at current valuations/conditions. "Passive" adherence to 60/40 today is largely the result of groupthink, recency bias, and unconsciously substituting the systematic vs. discretionary debate for the active vs. passive debate. The only advantage it offers is losing when everyone else loses. Misery loves company, but you may not have to be that company.

Next Week's Preview: Don't let a tax liability prevent reallocation to a better portfolio.